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No. 393

In the

Supreme Court of the United States

OCTOBER TERM, 1965

THE SILL CORPORATION,
Petitioner,

v.

UNITED STATES OF AMERICA,
Respondent.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE TENTH CIRCUIT

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No. .....

In the

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OCTOBER TERM, 1965

THE SILL CORPORATION,

Petitioner,

v.

UNITED STATES OF AMERICA,

Respondent.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE TENTH CIRCUIT

Petitioner prays that a Writ of Certiorari issue to review a judgment of the United States Court of Appeals for the Tenth Circuit.

OPINION BELOW

The opinion of the United States Court of Appeals for the Tenth Circuit is reported at 343 F. 2d 411 (the opinion is set out in full in Appendix A, *infra*).

JURISDICTION

The judgment of the United States Court of Appeals was entered March 3, 1965. The Petition for Rehearing was denied on April 27, 1965. The jurisdiction of this Court is invoked under 28 U.S.C. §1254(1).

QUESTIONS PRESENTED

I. Whether, in determining fair market value in federal condemnation proceedings under the capitalization of income approach, sales of non-comparable interests in admittedly non-comparable properties may be used to establish capitalization rate.

II. Whether, in determining fair market value by capitalization of income, debt service (principal, interest and insurance premiums on mortgage) may be deducted from the income to be capitalized.

III. Whether, in the condemnation of a Wherry Act Housing Project the amount of the Reserve for Replacement fund (a $167,000 cash reserve belonging to the petitioner that was required to insure ability to meet repair and maintenance expenses) may be deducted in computing fair market value where projected expenses for repair and maintenance were previously deducted as an expense in determining the income that was capitalized.

IV. Whether evidence may be introduced of a purported policy of the FHA effecting sanctions against windfall-excess mortgage proceeds (the difference between the cash mortgage proceeds received by the owner-builder and the owner-

builder's out-of-pocket cost to construct the project) where (1) admittedly no such policy was adopted by FHA in compliance with the Administrative Procedure Act and (2) even under the subsequent anti-windfall statutes no excess mortgage proceeds nor windfall existed in the case at bar.

STATEMENT

The Respondent United States brought the instant proceedings to condemn a Wherry Act Housing Project owned by the Petitioner Sill Corporation. The Capehart Act, enacted on August 11, 1955, 69 Stat. 635, as amended, 72 Stat. 663, 12 U.S.C. Sec. 1748, 42 U.S.C. Sec. 1549a(b), required government acquisition of all Wherry housing projects located at or near military bases where construction of Capehart housing had been approved.

The Fort Sill Project, completed in 1952, was mortgaged for $4,300,000 with an outstanding balance of $3,822,104 on the date of taking. (R. 11).[1] The condemnation value to the Petitioner-owner was determined by the trial jury to be $302,000 which result was affirmed by the United States Court of Appeals for the Tenth Circuit.

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[1] On the date of taking, September 1, 1959, (R. 10), the Fort Sill project consisted of 500 family units; 430 duplexes in 215 buildings; 70 single family units with 70 carports attached; 430 group carports in 46 buildings; one fully equipped laundry building; one project office building; and one maintenance shop building; situated on a landscape and planned leasehold of 122 acres. (R. 297-298). The lease was for 75 years and had some 66 years to run on the date of taking. (The improvements were owned in fee by the Sill Corporation with the right of removal at the expiration of the lease). Net cash income before debt service exceeded $300,000 each year; after dept service cash flow exceeded $60,000 annually. See n. 3 and 4 to Court's Opinion, Appendix A, *infra*.

Of the three condemnation approaches to value, *i.e.* (1) market data or comparable sales (2) capitalization of income and (3) reproduction cost minus depreciation, this Petition for Certiorari concerns questions of law principally relating to the utilization in federal condemnation proceedings of the capitalization of income approach to fair market value. Basically this approach involves the division of a property's *net income* by a *capitalization rate* to obtain value. (See examples and explanation in Appendix B, *infra.*)

The Petitioner unsuccessfully contended that the Government's method of capitalization was fundamentally erroneous. (R. 129, 203, 204). The Government's method was to deduct debt service (principal, interest, and insurance premium on mortgage) as an expense in computing net income and then to capitalize this net cash flow at a high interest rate (15% to 21%) to produce a figure supposedly indicating the owner's equity value. Petitioner claimed debt service should not be deducted from net income; that the overall value of the property should be determined and then the outstanding mortgage balance subtracted to give owner's net equity value. The court below although noting the great disparity produced by the two capitalization methods (some $800,000 in the case at bar) held that an expert could testify on the basis of either approach.

Over Petitioner's objections, the government was also permitted to introduce three sales of stock of other Wherry Housing Corporations to obtain a capitalization rate of 15% and 21%. (R. 82, 132, 134, 143, 144, 146). Such stock sales were not comparable to the ownership interest condemned

herein and were not introduced by Government as evidence of the fair market value of the present project. The Government successfully contended it could use the non-comparable sales for the limited purpose of establishing capitalization rate.

Petitioner further complained that double deductions were made for repair and maintenance items. The government witness, Sealy, in computing the net income to be capitalized, made deductions for projected repair and maintenance expenses. (Govt. Exhibit 97). After capitalizing such amount, Sealy then deducted the reserve for replacement fund of $167,000. The reserve for replacement fund belonged to the Petitioner and was not condemned as a part of the project. The cash reserve fund was required to insure the ability of the Petitioner to fulfill repairs and maintenance obligations. Petitioner unsuccessfully contended that the amount of the reserve of the replacement fund was not relevant in determining the fair market value of the project and second, the Government should not be permitted to make two deductions for repairs and maintenance charges. (R. 251, 918-919).

The district court by its pretrial order authorized the introduction of evidence relating to original cost (R. 81). Although the pretrial order recognized that original cost was not a direct indication of the present value of the condemned project (R. 81), it was received on the Government theory that future maintenance costs would increase to such point that the owner would have to request a future rent increase in order to maintain the level of net income. It was argued

by the Government that past "windfall"' would be considered under FHA policy in granting requests for future rent increases (R. 151-155). The Government claimed excess mortgage proceeds, or windfall profit, existed where the builder's *original* "out-of-pocket" cost was less than the principal amount of the FHA insured mortgage. At the time the Ft. Sill project was committed for insurance by the FHA the mortgages were pegged to 90% of the *FHA estimated* cost. The Petitioner objected to the irrelevant and prejudicial use of excess mortgage proceeds or windfall, because no windfall policy had ever been adopted by the FHA in accordance with the provision of the Administrative Procedure Act, no such policy could be validly adopted and given *retroactive* effect, and *no windfall existed* in the case at bar. (R. 105-110, 125-126, 161-163, 202, 329). Although no Government witness placed any substantial reliance on windfall in determining value, *the Government made use of its prejudicial effect in jury argument.*[2]

The court below affirmed the judgment of the federal district court and denied Petitioner's motion for rehearing. From such adverse determinations Petitioner seeks Certiorari.

---

[2] "Now if you count the interest that they've got their excess mortgage proceeds ran out somewhere more than $365,000.

"They said, 'Profit! Oh, well, we ought to have a profit.' And they said, 'Whoever heard of not having a profit?"

"Well, sure ladies and gentlemen, they ought to have a profit, but I'm telling you, $365,000 plus income for five or six years, plus $167,000 in the reserve for replacement that they got, plus what they are claiming here now is over $1,000,000. I say that's a pretty fair profit; and I think if this profit is increased only by $290,000 to $302,000, you've got pretty fair profit." (R. 965-966).

SUMMARY OF REASONS WHY WRIT SHOULD BE GRANTED

The decision below involves important principles of federal condemnation law relating to the capitalization of net income to determine fair market value. A decision by this Court will have a direct effect upon all federal condemnation cases using the capitalization of income approach to value.

The decision below in holding that the method of capitalization employed by the Government was not fundamentally erroneous conflicts with a decision of the Supreme Court of California, *De Luz Homes v. County of San Diego*, 45 Cal. 2d 546, 290 P. 2d 544, 557 (1955), holding the deduction of debt service from income to be capitalized totally erroneous in determining fair market value of a Wherry Project. The Government contended below its approach was correct because the Wherry owner had only a qualified right to a stream of income. This characterization of the ownership interest created by the Wherry program is contrary to the holding of this Court in *Offutt Housing v. Sarpy County*, 351 U.S. 253 (1956).

The decision below also approved the use of three Wherry Corporation stock sales which were not comparable and not introduced in evidence by the Government to establish value under the comparable sales approach to value, but for the purposes of establishing an invalid capitalization rate. This holding conflicts with a decision of the Seventh Circuit holding that the three Wherry stock sales which are not comparable cannot be utilized to establish a capitalization rate. *United States v. 190.71 Acres of Land in Lake County, Illinois*, 300 F. 2d 52, 60-61 (1962). The Government further

reduced value by taking a double deduction for repair and maintenance expenses first by deducting such costs from the income to be capitalized and then by deduction from the sum computed the $167,000 Reserve for Replacement Fund.

The question of the employment of a proper theory by an expert in giving opinion testimony to determining value is a matter of law for the court, *United States v. Honolulu Plantation* Co., 182 F. 2d 172, 178 (9th Cir. 1950). By forcing the jury herein to choose between two inconsistent theories of law the jury was prevented from fairly considering the evidence relating to a valid approach to value.

Although the Petitioner concededly fairly built the project according to FHA specifications and approval, the Government was allowed to interject prejudicial arguments that the Petitioner had made a windfall profit of some $365,000. (Claimed difference between builder's "*original cost*" and 90% of FHA *estimated cost* of $4,300,000). The evidence of "original cost" was received on the government theory that future rent increases could be denied by the FHA where excess mortgage proceeds (windfall) existed. The FHA, however, as the Government admits, never promulgated any policy regarding excess mortgage proceeds (windfall) in accordance with the Administrative Procedure Act. Thus such claimed policy would be a nullity. *FHA v. Morris Plan Company of California*, 211 F. 2d 756 (9th Cir. 1954); and see Document No. 95899, Survey and Study of Administrative Organization, Procedure and Practice in the Federal Agencies by the Committee on Government Operations, House of Representatives, 85 Congress, 1st Session. Further, no Gov-

ernment expert placed any substantial reliance on windfall in computing value. Finally, *no windfall existed in case at bar.* The $365,000 amount claimed was computed without regard to an allowable builder's fee and architect's fee (totaling $430,000 plus), and without regard to savings in material costs. The owners of the Sill Corporation (Petitioner) also owned and controlled the principal suppliers and instead of selling the material at the usual trade price, sold such materials to Petitioner at cost. This intercorporate bookkeeping profit *is not windfall.* Report (No. 29) of Special Subcommittee on Acquisition of Wherry Housing of the Committee on Armed Services, House of Representatives, 86th Congress, First Session 1959.

The Government by using a totally invalid method of capitalization, by using non-comparable sales to justify its capitalization rate, by making a double deduction for repair costs, and by using excess mortgage proceeds solely for purposes of prejudice accomplished the acquisition of the Petitioner's property without just compensation.

REASONS WHY WRIT SHOULD BE GRANTED

I. DECISION BELOW CONFLICTS WITH A DECISION OF THE SEVENTH CIRCUIT AND WITH A DECISION OF THE SUPREME COURT OF CALIFORNIA ON IMPORTANT FEDERAL QUESTIONS THAT SHOULD BE RESOLVED BY THIS COURT.

A. Importance in condemnation law of the capitalization of income to determine value warrant review by this Court.

The Acts of Congress in authorizing economical housing near important military bases for servicemen and their de-

pendents through private capital under the Wherry Housing Program, and in subsequent legislation requiring the acquisition of Wherry Projects when Capehart Housing was to be provided, evidence substantial public interest in the subject matter of the present cause. The importance of this cause, however, goes beyond a Wherry condemnation suit as the Questions Presented involve all condemnation proceeding using capitalization of income approach to value. For although the Government below attempted to justify its method of capitalization by claiming the Wherry owner had merely a limited right to income, such characterization of the Wherry owner's property interest is contrary to this Court's holding in *Offutt Housing v. Sarpy County*, 351 U.S. 253, 262;

> "* * * the full value of the buildings and improvements is attributable to the lessee's (Wherry owner) interest."

Indeed there are no significant differences affecting the economics of capitalization between the Wherry owner's interest than the owners of other investment properties with long term mortgages or deeds of trust.

The number of cases and general importance of condemnation proceedings has increased in recent years. The growth of Government programs, state and federal, will further increase the vast number of eminent domain proceedings. Where income producing property is condemned one of the principal standards by which experts determine value is through

the capitalizing of income. Although this Court has considered various condemnation cases, *there has been no decision by this Court upon the capitalization of income approach to value.* The need for a decision at this time stems from not only the conflict of the decision below with the Seventh Circuit on the use of non-comparable stock sales and the Supreme Court of California on deduction of debt service from the income to be capitalized, but to the importance in condemnation law that the problem be authoritatively resolved.

B. Decision below conflicts with decision of Seventh Circuit on use of other Wherry Sales to determine capitalization rate.

Selection of a proper capitalization rate is the fulcrum on which value depends. In this case the Government expert Sealy used a 15% rate; Monrad used 21%. (See n. 3 of the Opinion below, Appendix A, *infra*). A 15% rate applied to same net income would *lower* the value 2½ times over 6%. (See explanation and examples in Appendix B, *infra*). Since there are very few investments that return over 6% on capital, it was necessary for the government expert to rely on non-comparable sales on other Wherry projects to justify their exorbitant rate.

The opinion of the Tenth Circuit states that owner objected to use of "*comparable*" sales to determine capitalization rate. The Petitioner's objection, however, was clearly bottomed on the ground such sales were *not* comparable:

> "Your Honor, on 23 we object to it. There is no basis at this time on which the Court can say that those transactions are comparable, and the inclusion of the

phrase, even though widely separated geographically, automatically bars one of the tests of comparable sales of similar property." (R. 132-133).

Additionally the Petitioner filed extensive trial briefs[3] which clearly demonstrated the *stock* sales of the other Wherry projects occurring in a speculative or depressed market were not comparable on any recognized basis. (Defendant's Pre-trial Reply Brief, pp. 56-73, also R. 53-56).

Indeed the Government admitted that the sales of other Wherry projects were *not* sufficiently similar to constitute direct evidence of value under the market data (comparable sales) approach to fair market value.[4]

No comparable sales involving Wherry projects existed on the date of taking herein, September 1, 1959. No market existed for the subject project, the leasehold or the common stock of the Petitioner. If a "market" ever existed it ceased to exist more than three years prior to the date of taking by reason of the passage of Public Law 1020 on August 7, 1956. Public law 1020 made mandatory the condemnation of the subject project and all other Wherry projects located at or near military bases where construction of Capehart Housing had been approved. The purchase of any such Wherry project after August 7, 1956, would have been nothing more or less than speculation in the anticipated condemnation award and not a typical or normal real estate invest-

[3]Copies of the owner's printed pre-trial briefs have been filed with the record in this cause. (Copies were also filed with Court below).

[4]Government: "We don't say that they are actually comparable as structures or as to location, but they are bases for the witness's selection of his capitalization rate." (R. 54).

ment. It was because of Public Law 1020 that no sale of Wherry projects or *Wherry stock*[5] occurred after 1956.

On the use of other Wherry sales to determine capitalization rate there is a division between the Circuits. The decision below, the Second Circuit in *United States v. Certain Interest in Property (Fort Hamilton)*, 326 F. 2d 109 (1964), and the Ninth Circuit in *Winston et al v. United States*, 342 F. 2d 715 (1965), hold that such sales may be used. The Seventh Circuit decision on which Petitioner relied, holds to the contrary, *United States v. 190.71 Acres, etc.*, 300 F. 2d 52, 60-61 (1962):

> "The Government appears to concede that proof of comparability must be made before other sales can be employed for the purpose of determining compensation of the property to be taken. At the same time, it argues that proof of comparability is not necessary in order to employ other sales in determining value by the capitalization method. We think the fallacy of this position is exposed by statement on brief as follows:
>
> " 'In considering the Court's rejection in the present case of the 'comparable sales' offered by the Government, it is necessary to keep in mind the fact that the most basic aspect of a Wherry housing project, insofar as its monetary value to anyone is concerned, is its income potential. In translating that income, after expenses, into worth, great care must be taken in selection of the capitalization rate

[5] The sales of the Wherry projects involved sales of stock and not a sale of the full ownership interest as is being condemned by the government in the case at bar. The amount of just compensation must equate with the interest being condemned. A buyer obtaining the same interest as the government has condemned is in a superior position than a purchaser of stock because of a new depreciation schedule. It was uncontroverted in this case that the effect of a new depreciate schedule would result in tax free income to such to such purchaser for a substantial period of time. (R. 446).

> or multiplier to be applied. This is so both because of its embodiment of an estimate of the degree of risk and because of the immense leverage contained in each fraction of the percent or reciprocal selected. It is a fulcrum which multiplies each dollar many times.'
>
> "We discern nothing wrong with this statement. Certainly it is essential that the potential income be established and that the proper capitalization rate be applied. These are both dependent, however, upon the degree of risk involved, which is dependent upon many factors peculiar to each project * * *"

In determining the condemnation value of real property the District of Columbia has held the market value of stock of the corporate owner can not be considered: *In Re United States Commission*, 295 Fed. 950, 954 (D.C. Cir. 1924).

> "For the same reason the stress laid by the majority of the commission upon the present value of the capital stock of the corporation has little or no relevancy to the present inquiry. There may be many elements affecting the value of the capital stock, which have no bearing whatever upon the present fair value of the property. The indebtedness of the company, the competitive conditions affecting the business, the market for this class of stock are all elements affecting its value, but in no way bearing upon the fair value of the physical property of the corporation."

Because the sales introduced in evidence in this cause were not established by the Government to be comparable: (1) the sales price could not be offered in evidence to establish value; and (2) the income could not be offered in evidence to be compared with the income of the present project. The Government did and does not deny this, but successfully contends it may still use the noncomparable

sales for the limited purpose of establishing capitalization rate. The capitalization rate was attained by dividing the otherwise inadmissible net income of the noncomparable tract by the otherwise inadmissable sales price. A valid reason why the division of one inadmissible figure by another inadmissible figure produces a valid admissible figure has yet to be advanced by the Government. Petitioner submits that the court below should have followed the reasoning and holding of the Seventh Circuit in *United States v. 190.71 Acres, etc.*, 300 F. 2d 52, 60-61 (7th Cir. 1962), and the rationale of *In Re United States Commission*, 295 Fed. 950, 954 (D.C. Cir. 1924).

C. Decision below conflicts with Supreme Court of California holding on deduction of debt service from income to be capitalized.

Petitioner duly objected* that in determining value through capitalization of income it is erroneous as a matter of law

* The opinion below suggests that Petitioner acquiesced in the Government method. The court did, however, review the issue on the basis of whether it was "palpably erroneous." The Petitioner filed comprehensive trial briefs stating the objections and reasons for opposing the Government's deduction of debt service from the income to be capitalized. The Petitioner's counsel clearly voiced objections and reasons for opposing the Government's methods of capitalization on the basis that it was totally inadmissible. The trial court differed with counsel and held such method to be proper. The petitioner, by then seeking the full right of cross-examination, did not withdraw his objection to the unsoundness of the Government's approach. Indeed, the record reflects that at one point the Court interrupted Mr. Geraghty with the comment "Well you made your objection". (203). Since the instructions given to the jury were based on the pre-trial ruling that was adverse to the petitioner's owner, there certainly would be no waiver in failing to make a fruitless objection to instructions on grounds previously *entertained* and *rejected* by the Trial Court. Finally and decisively, if the Government method is wholly inadmissible then there would be as a matter of law no competent evidence to uphold the jury verdict. (See also R-129).

to deduct the amount of the debt service from the net income to be capitalized. Debt service is the amortization of the mortgage (principal and interest) plus mortgage insurance. The annual debt service in the case below exceed $250,000.00. Under the standard capitalization method the net income should be capitalized and then if a mortgage exists the amount of the balance should be deducted to determine the owner's net interest. This procedure was followed in *United States v. Certain Interest in Property in Cascade County*, 205 F. Supp. 745, 763 (Mont. 1962) and in *United States v. Chanute Gardens*, 271 F. 2d 379 (7th Cir. 1959). See Appendix B, *infra*.

The opinion of the court below states:

> "The Government's valuation witnesses, Monrad and Sealy, calculated value after debt service. Monrad estimated net income after debt service to be $63,300, which he capitalized at 21.5 percent. His estimate of value was $302,000. The cash flow in Sealy's opinion was $68,214, which he capitalized at 14.8 percent, the product being $455,100, from which he subtracted the reserve for replacement and reached a valuation of $290,000."

The owner's experts capitalized net income without deducting debt service, and then subtracted from the value computed the outstanding mortgage balance leaving a net value of $1,100,000 to $1,200,000.

The court below in holding the government method not to be "palpably erroneous" ruled:

> "It is indeed unfortunate that the divergent theories of income capitalization on which this case was submitted to the Jury inevitably result in a wide disparity on the

amount of money a willing buyer would pay for income producing property. Under the two theories, a willing buyer would pay $1,000,000 or $300,000, depending upon which appraiser he happened to employ and rely upon. Both theories have, nonetheless, been approved in adjudicated cases. Capitalization after deduction of debt service was approved in Likens-Foster Monterey Corporation v. United States, 208 F. 2d 595 [*] It was apparently used and approved in United States v. Tampa Bay Garden Apartments, Inc., 294 F. 2d 598 [*] The Owner says it was disapproved in DeLuz Homes v. County of San Diego, 290 P. 2d 544, a case involving a fair market value of a Wherry project for purposes of ad valorem taxes. Capitalization before deduction of debt service was used with approval in United States v. Certain Interests in Property, 205 F. Supp. 745; and United States v. Certain Interest in Property, 271 F. 2d 379.

"In this state of the law and in this posture of our lawsuit, we cannot say that either theory of income capitalization is so palpably erroneous as to be legally inadmissible."

Controvise, the Supreme Court of California in *DeLuz Homes v. County of San Diego*, 45 Cal. 2d 546, 290 P. 2d 544 (1955), expressly held deduction of debt service (amortization) to be erroneous as a matter of law:

"Furthermore, in determining the income to be capitalized to establish value for appraisal purposes, no deduction can be made for amortization. (Fisher, Nature of Capital and Income, pp. 238, 255). "(N)o concept of income which includes * * * depreciation in capital value as a positive or negative item of income, as ac-

* The opinions in *Likens-Foster* and *Tampa Bay* do not indicate any express approval or consideration of the deduction of debt service. The results in both cases were based on the standard method of capitalization that was used by the Petitioner's experts.

ceptable as a basis of valuation under the 'capitalized-income' method.' (Bonbright, op. cit. supra, p. 910 citing Fisher.) 290 P. 2d at 554.

"To deduct amoritization charges of the present lessee not only is to subtract a part of the very figure that is being determined, the value of the property, from the elements of the computation, but is to reach a valuation of zero in every case in which the lessee had estimated future earnings correctly and had invested their present value in the leasehold." 290 P. 2d at 558-559.

Although the *DeLuz* case involved capitalization to determine fair market value for taxation purposes, the issue therein resolved, whether the deduction of debt service is a permissible technique in capitalization income, *is the same issue presented below.* Thus Petitioner submits the *DeLuz* case is directly in point and that a conflict exists between the Supreme Court of California and the court below on the legal permissibility of the method of capitalization used by the Government herein.[7]

Value through capitalization of income can be obtained only by using net income prior to any deduction for debt service. The deduction of debt service is fundamentally erroneous because value is made to directly and substantially depend on a sum (debt service) which has no direct relationship with value. Here value would depend on the amount of mortgage which in turn was based on 90% of the FHA *estimated* cost made *prior* to construction!

[7] The Government below sought to distinguish *De Luz* because mortgage amortization could not be considered in computing value under the California statutes. The holding of *De Luz*, however, rested entirely on the ground that the deduction of debt service *was a totally invalid method of capitalization.*

In short, the amount of a mortgage does not control the value of the property, *e.g.*, if a house is truly worth $20,000, whether it has no mortgage, a $10,000 mortgage, a $20,000 mortgage, or a $40,000 mortgage, the value of the house is still $20,000. Now, true, a buyer in determining whether to assume a mortgage may be very interested in the amount of the mortgage and debt service as compared with the value of the property and its income. But the basic point is such comparison of the mortgage and debt service with value is made ***after the determination of value and not in the determination of value.*** In the case at bar the over-all value of the Wherry Project should be computed and then the amount of the mortgage outstanding should be subtracted in determining the amount due the owner. See Appendix B, *infra*, for comparison of Government and Standard method of capitalization.

Although noting the vast difference in result obtained by the theories of capitalization, the court below approved the use of both before the jury by expert witnesses. The law permits expert witnesses because the subject matter is such that a layman can not be expected to understand the technicalities involved. Paradoxically, the jury below was expected to choose between two inconsistent legal theories that had been approved by the court. See R. 991.

A party under the guise of expert testimony cannot offer *opinion evidence* of value based upon unsound theories or upon incorrect manipulation of sound theories. This is not a discretionary evidentiary ruling but at an issue of law. The

Ninth Circuit in the case of *United States v. Honolulu Plantation Company*, 182 F. 2d 172, 178 (9th Cir. 1950) ruled:

> "*Opinion evidence is not evidence of fact.* The trier of fact is not bound to follow the expert. Based upon unwarranted theorems of the experts, the Judge found 'severance damage' to the properties as a whole. Where unwarranted theories of law or assumptions of fact guide the expert and are used as a basis for value by the Court, the evaluation will be set aside and the cause remanded for new findings." (Emphasis added).

The complexity of the capitalization process coupled with the inability of some otherwise intelligent persons to comprehend mathematical manipulations, requires the court to shield the jury from unsound techniques.

A further manipulation of figures was made by the Government witness, Sealy, who, after deducting repair cost from the income to be capitalized, deducted from the sum computed the $167,000 Reserve for Replacement fund. The reserve was a mandatory cash reserve fund belonging to the Sill Corporation and was not condemned. The Wherry project, owned by the Sill Corporation, and not the Sill Corporation itself was taken by the Government. Thus, the full amount of the reserve for replacement fund was, previous to the adjudication below, returned to Sill. (R. 987). The government's witnesses' computation constituted a double deduction. In capitalizing income to ascertain value the present condition of the property ordinarily is not relevant as long as the property is producing income. The present physical condition of the property will be reflected in estimates of gross and net income in the following manner: (1) estimate of occupance rates (2) use-

ful life, and (3) maintenance and replacement. For example, if maintenance and replacement expenses are estimated at $30,000 per year and are deducted from income this would reduce over all value some $230,585 ($30,000 capitalized at 6% for 35 years). If no deduction is made from income because of maintenance and replacements, etc., then, of course, it would be proper to adjust the final figure. It is not proper to adjust twice for the same expenses.

The confusion now existing with the capitalization of income approach to value, an approach used in evaluating nearly all investment properties, would be greatly clarified by a decision of this Court. As the law now stands *juries* are fair game for expert witnesses adroitly applying misleading mathematical manipulations.

II. THE DECISION BELOW IN APPROVING GOVERNMENT USE OF ALLEGED WIND-FALL PROFIT OR EXCESS MORTGAGE PROCEEDS VIOLATED IMPORTANT PROVISIONS OF THE FEDERAL ADMINISTRATIVE PROCEDURE ACT WARRANTING REVIEW BY THIS COURT.

Excess mortgage proceeds or windfall profit was claimed to have existed where the builders out-of-pocket cost was less than the principal amount of the FHA insured mortgage. At the time of the Fort Sill project mortgages were pegged to Ninety (90) per cent of the FHA estimated cost. The Government claimed that evidence of original cost and excess mortgage proceeds were relevant and admissible because a purchaser of Wherry Project allegedly could, under proported FHA policy, be denied future rent increases because

of existence of past windfall profit. The Petitioner objected to such irrelevant and prejudicial evidence for four basic reasons (R. 105-110, 125-126, 161-163):

1. No valid policy was ever adopted by FHA with reference to such proceeds;

2. In order to enforce any policy on excess mortgage proceeds against owners and/or future owners of Wherry projects, it would be necessary to promulgate such policy in accordance with applicable statutes;

3. No valid policy could be promulgated in reference to the owners of Fort Sill because the so-called windfall profits or excess mortgage proceeds were valid at the time Fort Sill was constructed. (Indeed, this was one of the inducements to encourage private risk capital to provide the housing projects for the benefit of servicemen and their dependents.);

4. *No windfall existed in the case at bar* as windfall was defined by the subsequent anti-windfall statutes.[8]

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[8] The concept that a windfall exists when the mortgage proceeds exceed the mortgagor's original cost accounting-wise cannot be applied until the term original (actual) cost is defined. No rule nor regulation has ever been promulgated by the FHA that in any way defines the items that are to be included or excluded in determining "original" or "actual" cost. Not even Government exhibits 42 and 43, erroneously relied upon by the Government to establish the existence of the windfall policy, define windfall. The Government witness Jefferson, a former Assistant Commissioner of the FHA, who admits that he was the "conscience of the Agency" (R. 678) testified windfall meant:

> "It is, as I see it, what the name implies. The excess of the mortgage over the direct out of pocket expenses by the contractor for performing the construction contract, limited to such expenses as were incurred in the site or on the job." (R. 680).

(continued on next page)

The court below held that no error existed for the following reasons:

> "Under the lease contract, the FHA, as we have seen, was empowered to regulate rates, charges, capital structure, rate of returns, and methods of operations, and it was certainly relevant for a prospective purchaser to know that in the event increased rentals were needed in order to maintain the level of capitalized income, the FHA would invoke its policy in the fact of excess mortgage proceeds. This was the extent to which the excess

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(continued from the preceding page)

This definition is even more strict than the second anti-windfall statute which limited the FHA mortgage to 90% or mortgagor's actual cost as distinguished from 90% of the FHA estimated cost allowed by the statute in effect at the time this project was completed. That statute defines "Actual cost" in relevant part, as follows:

> "* * * the actual cost to the mortgagor, of such construction, including amounts paid for labor, materials, construction contracts, off-site public utilities, streets, organizational and legal expenses, and other items of expense approved by the commissioner plus (I) a reasonable allowance for builder profit if the mortgagor is also the builder as defined by the commissioner, and * * *" P. L. 560, 68 Stat. 608.

The Government claim of more than a $365,000 windfall was computed without regard to the allowable builder's fee (8% $340,433) and, an allowable architect's fee (2% — $91,917), or that the mortgagor-builder of the Ft. Sill project owned and controlled its principal suppliers. (See also R. 905-908).

Where the mortgagor-builder is also the supplier or controls the supply and material concern, whether the builder or supplier incurs the profit or savings is a mere bookkeeping entry. It is not windfall. This was recognized in the Report (No. 29) of Special Subcommittee on Acquisition of Wherry Housing of the Committee on Armed Services, House of Representatives, 86th Congress, First Session 1959 pg. 1957;

> *"When the builder and the sponsor are the same party, what appears to be 'mortgaging out' or a windfall may not be so in fact.* For example, the sponsor may not have taken his allowable builder's profits in cash, but may have left them as a contribution to equity. In early projects an architect's fee of up to five percent was allowed; and sometimes the sponsor's employees performed these services at a fraction of the allowable fee, with the balance representing a contribution to equity. In some cases the sponsor may have owned, for example, a cinder block plant, and supplied the block at cost, preferring to take equity rather than cash for his profit on the cinder block." (Emphasis added).

> mortgage proceeds and windfall was used in the Government's case, and it was not irrelevant for that purpose."

With deference, the above holding conceivably might have some merit *if* the Government had adopted a *valid* policy in regard to excess mortgage proceeds or windfall *and if* windfall had *existed* in the case at bar. When the Government concedes, as recognized by the court, that no valid policy was adopted, there is absolutely no basis for admissibility into evidence of such policy. To hold otherwise would permit any Government agency to manufacture admissible evidence of policies which are void and invalid for failure to comply with duly enacted laws of Congress, and to use such contrived and invalid policy to acquire property rights which the Constitution decrees may not be taken without due process of law.

The decision below contravenes the very purpose of the Administrative Procedure Act and is contra to the rationale of *FHA v. Morris Plan Company of California*, 211 F. 2d 756 (9th Cir. 1954), which held FHA statements of policy did not have the dignity of regulations and therefore were not binding. The court therein expressly stated:

> "Early in the trial of the case the trial court correctly ruled that the statement of policy issued by FHA had no binding effect upon appellee and could not properly be considered a part of the contract." 211 F. 2d at 757-758.

The Government's position in this case also flatly contradicts the position of the Agency as announced to the Congress.

On January 8, 1957, subsequent to the anti-windfall acts, to the Capehart Act and its amendment requiring condemna-

tion of Wherry projects, and to Government exhibits 42 and 43, the Administrator of the Housing and Home Finance Agency, of which agency the Federal Housing Administration is a constituent unit, officially replied to a questionnaire transmitted to him by the Chairman of the Committee on Government Operations of the United States House of Representatives on November 19, 1956, in pertinent part as follows: (Document No. 95899, Survey and Study of Administrative Organization, Procedure and Practice in the Federal Agencies by the Committee on Government Operations, House of Representatives, 85th Congress, 1st Session).

> "* * * the rules and regulations are issued covering each of the insurance programs of the FHA, and are set forth in detail in title 24, parts 201 to 297 of the Code of Federal Regulations * * *.
>
> "The principal charges in rules are made necessary in one or more of three general circumstances: (1) Passage of an amendment to the basic statute; (2) to close gaps in prescribed requirements by furnishing more details information; and (3) *to reflect changes in policy applicable only to future insurance contracts* * * *.
>
> "*Changes in the FHA rules do not affect the rights and obligations of the parties under existing contracts,* and may be compared favorably with changes in contract forms to be utilized in the future * * *.
>
> "The FHA makes no rulings in the sense that rulings are made by regulatory agencies. *The materials promulgated by the agency, which amount to statements of eligibility requirements for the several insurance programs, appear in the Federal Register and the Code of Federal Regulations* * * *" Document 95899, supra, at page 1650, 1652, 1654. (Emphasis supplied.)

The FHA, insofar as the Wherry Act is concerned, is not exempt from the publication requirements of the Adminis-

trative Procedures Act (60 Stat. 237 (1946) as amended, 5 U.S.C. 1001(a)), and the policies and procedure referred to come within the Act. (Sec. 1002(a)). The claimed power to reduce rents or deny a future rent increase constitutes a "sanction" under the terms of that Act. (60 Stat. 237, 242, as amended, 5 U.S.C. 1001(F), 1008(a)).

The Administrative Procedures Act and the Federal Register Act are not mere recording statutes. A rule or policy falling within the provisions of the Administrative Procedures Act which has not been processed in compliance with its provisions is of no force or effect and unenforcible. *Hotch v. United States*, 212 F. 2d 280, 283 (9th Cir. 1954).

The admissibility and relevancy of "windfall" or excess mortgage proceeds in Wherry condemnation suits was discussed by the *Second Circuit which held that such evidence was not admissible and would have been prejudicial except that the owner therein had invited the error.*

> "The defendants find error in the judge's charge that it was undisputed that defendants had received a windfall, i.e. the amount of the mortgage was greater than the actual cost of construction. Not only was this untrue but whether defendants had received a windfall was totally irrelevant to determination of the present value of the leasehold although it might affect the jury's attitude toward defendants. However, Schlicta's testimony presented the matter accurately and fairly. If the defendants had not insisted on emphasizing the issue, there would be no question at all of prejudice. In the light of the record as a whole, the charge was not sufficiently prejudicial to justify upsetting the verdict," *United States v. Certain Interest in Property Etc., (Fort Hamilton)*, 326 F. 2d 109, 116, n. 7 (2d Cir. 1964). (Emphasis added).

In the case at bar the owner's counsel vigorously objected at pretrial and trial to the admission of evidence of original cost and excess mortgage proceeds. (R. 105-110; 125-126; 161-163; 202; also, 50, 51, 128, 150, 165, 166, 167, 199, 200, 208).

Finally, contrary to the holding below, inadmissible evidence can not be made admissible in condemnation suits under the guise that a well informed buyer would like to know the information. To illustrate, a well informed buyer would certainly like to know about other offers — but offers are not admissible as was held in a well reasoned opinion. *United States v. Regents of New Mexico School of Mines*, 185 F. 2d 389, 391 (10th Cir., 1950):

> "It is the general rule that evidence of specific offers of purchase is not admissible for the purpose of establishing the reasonable market value of property. The primary reasons underlying the rule are that evidence of that kind is often speculative, usually no opportunity is afforded for cross-examination of the persons said to have made the offers and collateral inquiries are injected into the case which may tend to confuse the main issue."

By the improper Government trial tactics regarding windfall, the owners of Sill Corporation were cast in the eyes of the jury as profiteers whose conduct if not illegal was at least highly reprehensible. The Government trial tactics were successful, but with all due deference, we do not believe acceptable in a court of the United States. The Government as a litigant has a higher duty to accomplish justice than to win by any possible way the outcome of a particular case.

Berger v. United States, 295 U.S. 78, 88 *and Viereck v. United States*, 318 U.S. 236.

The Government experts did not place any substantial reliance on windfall in determining value and even opposed an order of proof;[9] *instead* exactly as the Petitioner had warned the trial court[10] the Government utilized it solely for purposes of prejudice:

> "And ladies and gentlemen, the facts about these excess mortgage proceeds are here by their own admission. Not only did they fail to put one dime into the project, but they put in their pocket $365,000 of the mortgage proceeds.
>
> "In addition to that, in addition to that somewhere prior to March 31, somewhere in March 1953, I believe it was before they had to make their first debt payment, they had the privilege of getting a lot of this income debt free.
>
> "Now if you count the interest then they've got their excess mortgage proceeds ran out somewhere more than $365,000.

[9] The Petitioner, in chambers on the second day of trial requested: "Now it is our view that there should be a rule as to the order of proof on that (original cost-windfall), and we would think that order should be that no evidence of cost will be permitted until such time as it appears that an evaluation witness had placed some reliance, substantial reliance on that as affecting the valuation, or his opinion of value." (R. 329). The government assured the court that "there is going to be a tie-up on this matter of original cost." (R. 329). The owner's request was denied. The Court: "Well, it will be the ruling of the Court that original cost will be permitted. I will let him (government counsel) go into it on his (cross) examination and I know he should connect it up some. I am satisfied he will." (R. 335). The government never did "tie-up" the original cost-windfall argument with evaluation. No government witness placed any substantial reliance on windfall in determining value. (R. 776-777, 846).

[10] R. 167: "The object of this, your Honor, is to inflame the jury, prejudice them in their mind against the owners. Windfall has nothing to do with value."

"They said, 'Profit! Oh, well, we ought to have a profit.' And they said, 'Whoever heard of not having a profit?'

"Well, now, ladies and gentlemen, they ought to have a profit, but I'm telling you, $365,000 plus income for five or six years, plus $167,000 in the reserve for replacement that they got, plus what they are claiming here now is over $1,000,000. I say that's a pretty fair profit; and I think if this profit is increased only by $290,000 to $302,000, you've got pretty fair profit." (R. 965-966).

CONCLUSION

For the foregoing reasons this Petition for Writ of Certiorari should be granted.

Respectfully submitted,

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APPENDIX A

United States Court of Appeals

Tenth Circuit

January Term, 1965

No. 7607

THE SILL CORPORATION,

Appellant,

v.

UNITED STATES OF AMERICA,

Appellee.

Appeal from the United States District Court for the Western District of Oklahoma

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John J. Geraghty (Josiah G. Holland, William VanDercreek and Roland Boyd were with him on brief) for Appellant.

Raymond N. Zagone (Ramsey Clark, B. Andrew Potter, David A. Kline, Roger P. Marquis, Robert M. McKee were with him on brief) for Appellee.

Before MURRAH, Chief Judge, and PHILLIPS and LEWIS, Circuit Judges.

MURRAH, Chief Judge

The Sill Corporation, owner-sponsor of a Wherry housing project (See 63 Stat. 570, 12 U.S.C., Secs. 1748, et seq.) appeals from a judgment on a jury verdict awarding it "just

compensation" for the taking of its interest in the project. The owner's interest was taken pursuant to the amended provisions of the Capehart Act [See 70 Stat. 1111, 42 U.S.C. (1952 ed., Supp. V), Sec. 1594(b)], whereunder the Secretary of Defense was directed to acquire all Wherry projects where Capehart housing had been approved and constructed.[1] Under the Wherry Act, the Federal Housing Authority (FHA) was authorized to insure mortgages up to 90 percent of the estimated cost of construction. All mortgagor-owners were subject to FHA regulations in such matters as rents, charges, capital structure, rate of return and methods of operation. See *Buena Vista Homes, Inc. v. United States* (CA 10), 281 F. 2d 476.

The Sill Corporation was formed as a sponsor solely to take advantage of the unique economic benefits available under the Act. It constructed 500 such rental units on 122 acres of leased Government property near Ft. Sill, Oklahoma. The ground lease, drawn in 1950, was for 75 years at an annual rental of $100. It provided that title to all improvements constructed by the sponsor remained in its name for the duration of the lease, but upon expiration or termination, the improvements became the sole property of the Government, unless the sponsor elected to remove them and restore the premises. Financing of the project was accomplished by an FHA insured mortgage of $4,300,000 for 34 years from the date of its issuance in October, 1951.

[1] This requirement was imposed to avoid competition between the Wherry projects and the newer Capehart projects. See 3 U.S. Cong. News, p. 4551, 84th Cong., 2nd Session.

Acting under authority of the amended provisions of the Capehart Act, the Government instituted these proceedings, took possession of the property and, at the same time, assumed the unpaid mortgage balance of $3,822,104.55.

On pretrial, the parties apparently agreed that capitalization of net income was an appropriate method for determining the fair market value of the Owner's interest in the project. But the parties disagreed on the factors to be taken into account in determining the net income to be capitalized. The Government took the position that fair market value was determinable by capitalizing net income after deduction of debt service, i.e., the cost of mortgage amortization and insurance. The Owner contended for capitalization of net income before deduction of debt service. Paragraph 21 of the proposed pretrial order recited that "the following methods shall be considered as proper approaches to the determination of the value of the estate being condemned:

"(a) Market data; determined by comparison with actual comparable sales of like property prior to September 1, 1959.

"(b) Capitalization of net income before debt service.

"(c) Capitalization of net income after debt service."

The Owner first objected to paragraph 21 in its entirety, specifically complaining that subparagraph (c) was improper because it permitted the jury to choose between capitalization before or after deduction of debt service. However, the Owner finally acquiesced in the pretrial order, provided it was not restricted in any way on cross-examination to demonstrate the "mathematical fallacy" of subparagraph (c) as a principle of capitalization of income to arrive at fair market

value as a measure for just compensation. A parenthetical addendum providing, "with full right of proper cross-examination covering the above approaches." was attached to subparagraph (c), and the parties proceeded to trial under the pre-trial order as a part of the trial blueprint.[3]

Upon trial to the Jury, the parties were permitted without objection to produce expert testimony of fair market value upon their respective theories of net income for purposes of capitalization. Making application of the Government's theory of capitalization of net income or "cash flow", two appraisal experts testified that the fair market value of the estate taken was $294,000 and $302,000, respectively.[4] Applying the Owner's theory for determining net income, its four appraisers testified that the fair market value of the estate taken was $1,100,000, $1,111,000, $1,200,000 and $1,379,895, respectively.[5] Each of the appraiser-witnesses was

[3] Throughout the pretrial proceedings, the Owner apparently continued to object to the capitalization of net income after debt service for the purpose of evaluation of the property. Owner's counsel was apparently apprehensive lest he be precluded from developing his case on his own theories of evaluation.

[4] The Government's valuation witnesses, Monrad and Sealy, calculated value after debt service. Monrad estimated net income after debt service to be $63,300, which he capitalized at 21.5 percent. His estimate of value was $302,000. The cash flow in Sealy's opinion was $68,214, which he capitalized at 14.8 percent, the product being $455,100, from which he subtracted the reserve for replacement and reached a valuation of $290,000.

[5] The Owner's witnesses, Vaughan, McKean, Noah and Williamson, capitalized net income before debt service. Vaughan capitalized an estimated income of $323,785 before debt service at 6 percent for a 40-year period and then subtracted debt service, reaching a value opinion of $1,379,895. McKean capitalized $316,391 at 6¼ percent for a 50-year period, subtracted the unpaid debt, and testified to $1,111,000 as value. Noah's valuation opinion of $1,200,000 was reached by his capitalizing $319,157 by 6¼ percent over the remaining years of the lease; he then subtracted the mortgage balance leaving $1,200,000 as value. Williamson capitalized $322,297 at 6¼ percent for a 50-year period, subtracted the mortgage balance, and by that process estimated compensation at $1,100,000.

cross-examined extensively, without let or hindrance, concerning his theory of evaluation.

Consistent with its pretrial order, the Court specifically instructed the Jury, "All of the expert witnesses for both parties have used the capitalization of income approach and all have applied this approach in one or both of the following methods of capitalization:

"The projected net income, after payment of fixed charges, all expenses, and the annual amount required by the commitment for the reserve for replacements fund, and before allowance for depreciation and debt service, which includes principal and interest payments and the mortgage insurance premium is capitalized, producing the capitalized value of the net income, and thus the indicated value of the conditional ownership in the leasehold estate. The indicated value of the equity, that is, the interest of the sponsors or defendant here as encumbered by the mortgage, is then determined by deducting from the capitalized value of the net income the unpaid balance of the mortgage.

"The projected net income, after payment of fixed charges, all expenses, the required payment to the reserve for replacement, the debt service, which includes principal, interest and mortgage insurance premiums, but before any allowance for depreciation, is capitalized producing the capitalized value of the net cash flow and, therefore, the indicated capitalized value of the ownership interest which earns such net cash flow.

"You will note that the words 'indicated value' are used to define the results reached by these methods of capitalization. This 'indicated value' may or may not be the fair market value. This approach, under either method, contemplates that the seller would receive and the buyer would give the price indicated provided that the income is free and clear of further charges and free and clear of further payments other than the purchase price. If there are charges in addition to that allowed in reaching the net income before debt service, or the net income after debt service, or if there are payments required other than the purchase price, further adjustments may be required."

We must assume, of course, that the Jury understood and intelligently applied these instructions. In oral argument Owner's counsel exhorted the Jury not to compromise the divergent theories on net income capitalization, but to accept one and reject the other. The Jury apparently accepted counsel's plea, and, by its verdict of $302,000, obviously chose the Government's theory of net income for capitalization purposes.

The Owner now strenuously complains of that part of the Court's instructions which permitted the Jury to determine fair market value by capitalization of net income after deduction of debt service. Although the Court's instructions were submitted to the parties and suggestions solicited, neither party objected to the submission of the choice of methods for determining net income for capitalization pur-

poses.[5] The Owner did request the Court to instruct the Jury that "payments on the principal of the mortgage indebtedness * * * are not an expense item and to treat them as such would improperly reduce the evaluation." It is not entirely clear whether this request was intended to challenge the Court's instructions on choice of capitalization theories. If so, we seriously doubt whether it meets the requirements of Rule 51, F.R.C.P. See *Downie v. Powers*, 193 F. 2d 760. But, even so, we think the challenge comes too late in view of the apparent pretrial agreement of the parties on the blueprint of the lawsuit embodying their respective theories of income capitalization and the introduction without objection of testimony in support of those respective theories. No one should be heard to object to an instruction on the law of the case on which it was tried and submitted by agreement of the parties. We ought not to disturb the Jury's

[5] When the parties came to discuss the Court's proposed instructions in an In Chambers Conference, counsel for the Owner objected to the first and second paragraphs on page 22 of the Government's requested instructions (Instruction 17 on capitalization of net income). The ensuing colloquy plainly indicates that counsel was objecting to the Court's treatment of the "reserve fund for replacement". The burden of the objection was that the instruction on this point constituted an unwarranted "comment on evidence on which conflicting views had been expressed by the witnesses" that "The Court would in effect be directing a verdict on a point in issue". The ground for objection to the second paragraph of the instruction was that it conflicted "with the basic concept of market value because it must assume that the property could be sold on the open market". The Court took the matter under advisement as one of the "two points that I am to consider a while longer". There were no objections to the submission of the choice of methods for determination of income for capitalization purposes, also included in Requested Instruction 17. The Court instructed the Jury on choice of theories of net income in accordance with the pretrial order. When, at the conclusion of argument and before the case was submitted to the Jury, counsel was asked for further objections to the instructions, the Owner's counsel responded that he had none other than those "we recorded this morning."

verdict unless we are convinced that it is made to rest upon a palpably erroneous rule of capitalization used to measure fair market value for the purposes of just compensation.

We know, of course, that the law is not wedded to any particular formula or method for determining fair market value as the measure of just compensation. See: *United States v. Miller*, 317 U.S. 369; and *United States of America v. Leland Sowards, et al.*, (10 CA), 339 F. 2d 401. It may be based upon comparable sales, reproduction costs, capitalization of net income, or an interaction of these determinants. The parties agreed in this case that the capitalization of income is the most satisfactory method. The parties also agree, as they must, that the test of fair market value is the amount of money a willing buyer would pay for the future net income, when computed at its present value.

It is indeed unfortunate that the divergent theories of income capitalization on which this case was submitted to the Jury inevitably result in a wide disparity on the amount of money a willing buyer would pay for income producing property. Under the two theories, a willing buyer would pay $1,000,000 or $300,000, depending upon which appraiser he happened to employ and rely upon.[6] Both

[6] The Government contends that debt service must be subtracted from income before capitalization because this is the only manner in which equity income would be considered by prudent buyers and sellers of equity investments. See: Kaffenberger, "Market Data in the Appraisal of Income Property", *The Appraisal Journal* 57-62 (1960). And, that a buyer would only be interested in what income he would receive on his investment after all expenses, including debt service, had been deducted. It argues that in the final analysis this technique is a closer approximation of what investors would consider the value of the sponsor's interest, than the formula relied upon by the Owner where debt service has little or nothing to do

(Continued on next page)

theories have, nonetheless, been approved in adjudicated cases. Capitalization after deduction of debt service was approved in *Likens-Foster Monterey Corporation v. United States*, 208 F. 2d 595. It was apparently used and approved in *United States v. Tampa Bay Garden Apartments, Inc.*, 294 F. 2d 598. The Owner says it was disapproved in *DeLuz Homes v. County of San Diego*, 290 P. 2d 544, a case involving a fair market value of a Wherry project for purposes of ad valorem taxes. Capitalization before deduction of debt service was used with approval in *United States v. Certain*

(Continued from preceding page)
with determining value. The Owner contends that capitalization of income after deduction of debt service is wholly inadmissible because it allows the amount of the mortgage to control the value of the property. In other words, the payment of the mortgage has been a use of net income rather than an element which determines net income; thus, the over-all value of the Wherry project should be computed before deduction of the mortgage debt, the amount of the outstanding mortgage then being subtracted in determining the sum due to the owner as just compensation.

There are statements in texts on appraising income property to the effect that "when determining net income for the purpose of appraisal, amortization of mortgage or any interest paid are to be disregarded. This becomes clear if one can conceive of a property whose entire earnings are being paid out in interest and amortization of a mortgage." *Real Estate Principles and Practice* by Maurice A. Unger (South-Western Publishing Co. 1954). The fallacy of this argument may lie in the fact that the only interest taken here is a possessory right in a lease. This reasoning would be applicable if the owner in this case acquired an equity through the amortization of the mortgage. The mortgage payments, although commensurate with the income, would nevertheless operate to enhance his equity in the property. But, in our case, the owner can acquire no equity in the mortgaged property. The nature of his estate therein is purely possessory — the right to the income or the benefits, after discharge of all of the burdens. When the mortgage indebtedness is finally satisfied, the Owner does have a residual right in the leasehold with a right to remove the improvements, but if they are not removed, they become the property of the Government and no one here contends that this was considered as a factor in determining whether the debt service should be deducted before or after capitalization.

Interests in Property, 205 F. Supp. 745; and *United States v. Certain Interests in Property*, 271 F. 2d 379.

In this state of the law and in this posture of our lawsuit, we cannot say that either theory of income capitalization is so palpably erroneous as to be legally inadmissible.

It is agreed that one of the principal keys in the capitalization of income process is determination of the capitalization rate, i.e., that percentage which will provide for the recapture or amortization of the value of the investment in the improvements, plus a reasonable and proper rate of return to the investor. This is true, of course, whether the income to be capitalized is calculated before or after the deduction of debt service. The owner objects to the use of comparable Wherry Project sales as a factor in the determination of the capitalization rate.

The determination of the capitalization rate entails consideration of many risk factors which may influence a prospective purchaser in determining fair market value. In our case, the Government witnesses and at least one of the Owner's witnesses considered sales of stock in other Wherry housing corporations as comparable for the sole and only purpose of arriving at an appropriate capitalization rate. The Jury was instructed in accordance with the pretrial order that, "To the extent that other properties or investments are actually similar or comparable to the property involved in this action from the viewpoint of the quantity and quality of the income stream and the limitations and risks attendant thereto, the capitalization rates, multipliers and

income-price ratios resulting from these transactions are the highest and best evidence of the proper capitalization rate, multiplier or income-price ratio to be applied in the capitalization of the projected income of this project." As we interpret this instruction, it is simply to the effect that comparable sales of Wherry projects to the extent that they are comparable is relevant evidence in determining the capitalization rate.

Case authority appears to clearly favor the trial court's instruction on this issue. The most recent and comprehensive discussion of the matter is found in *United States v. Certain Interests in Property*, 326 F. 2d 109. There the Second Circuit held that the admission of evidence of comparable sales for the sole purpose of establishing the ratio between income and sale price was entirely within the discretion of the trial court. See also: *United States v. Delano Park Homes, Inc.*, 146 F. 2d 473; *United States v. Johnson*, 285 F. 2d 35; *United States v. Certain Interests in Property*, 186 F. Supp. 167, aff'd sub. nom.; and *Likens-Foster Monterey Corp. v. United States, supra.*

The principal case relied upon by the Owner is *United States v. 190.71 Acres of Land*, 300 F. 2d 52, where the appellate court upheld the trial court's rejection of comparable sales as direct proof of value, not to determine capitalization rate.

The Owner also objects to the deduction of the reserve for replacement fund from the amount of just compensation. Wherry leases require the lessee to make annual contributions to a replacement fund, to insure that necessary replace-

ments, such as stoves and refrigerators will be made. The Government had assumed the obligation of replacement, and the replacement fund, which then amounted to approximately $167,310, was refunded to the Owner. In reaching his final estimate of fair market value, one of the Government's appraisal experts deducted the replacement fund from his estimate of capitalized net income. The Owner objected to the instruction given by the Court relating to the replacement fund, which in effect left open the question of whether the deduction was proper.[7] The Owner relies on *Buena Vista Homes, Inc. v. United States, supra*, and *United States v. Certain Interests in Borough of Brooklyn (Fort Hamilton)*, 326 F. 2d 109. We think Judge Breitenstein answered the question against the contention of the Owner in *Buena Vista Homes, Inc.*, when he stated that, "In fact,

[7] The trial court specifically instructed the Jury that, "the defendant was required to establish and maintain with the mortgagee, as escrow agent, a reserve fund for the replacement of short lived items, such as stoves, refrigerators, hot water heaters, and so forth, by depositing in said fund in monthly installments, the annual amount of $27,115. At the date of taking the accumulated amount in the reserve fund was $167,316. By agreement between the Commissioner of the Federal Housing Administration, the Department of the Army, and the mortgagee the total amount of this accrued fund was turned over to the defendant at or about the time of taking.

"You are instructed that the obligation to deposit this annual amount was a contractual one and binding upon the defendant for the term of the lease. No withdrawals could be made from that fund without the prior approval of the Commissioner of the Federal Housing Administration during the term of the Federal Housing Administration insured mortgage. None of the expert witnesses were entitled to assume that the terms of these contractual obligations could be varied by the defendant or his purchaser or successor in interest.

* * *

"You may consider this testimony and its effect, favorable or unfavorable, on the fair market value of the rights acquired by these proceedings and give it such weight and such effect you deem justified."

the fund was not available to the condemnor as it had been returned to Buena Vista. Accordingly, the entire repair and replacement cost had to be deducted from the capitalization of income figure to arrive at the fair market value." ibid., p. 480.

Here, as in *Buena Vista*, there was testimony to the effect that the condition of the property required repair, and in deducting this amount for the capitalization of income, the expert witness assumed that the accrued replacement fund would not be available for that purpose. In these circumstances it was not improper to permit the Jury to consider this testimony in determining fair market value. On pretrial the Court excluded evidence of reproduction costs as not being an acceptable basis of evaluation, and the Owner complains of it here. Judge Breitenstein also answered this question in *Buena Vista*, holding that "the condemnee's rights with respect to the property were limited by the fact that the projects were subject to rent control by Federal Housing Administration and the consistent policy in regard to such projects had been the allowance of a return based on original cost rather than reproduction cost." ibid., p. 478.

Finally, we come to the asserted reversible error in the ruling of the Court on admissibility of evidence of excess mortgage proceeds and its characterization as a "windfall" in the testimony of witnesses and the Government's argument to the Jury on this point. From the very outset of the pretrial proceedings, the Owner apparently realized the detrimental effect of any reference to excess mortgage proceeds

over the certified cost of construction, and particularly its characterization as a "windfall". The pretrial order provided that, "Neither counsel nor any witness for either party shall, in the presence or hearing of the jury, use the word 'windfall' in the trial of this case unless approval is obtained in advance from the court; however, the words 'excess mortgage proceeds' may be used. The pretrial order also provided that "Evidence of the actual cost of construction shall be admitted * * *, solely as evidence as to what a willing, prudent buyer and seller would contemplate or expect in the way of income or rental ceilings in the future under the authority of the Commissioner to regulate and restrict the rentals."

At the time the loan was made, the excess mortgage proceeds over the actual cost of construction could not rightly be called a "windfall". Rather, it constituted money, the use of which inured to the Owner only during the amortization period of the mortgage. When, however, the Government took the property, assumed the indebtedness and refunded the replacement funds to Sill, the excess mortgage proceeds inured to the Owner without any obligation to repay them. These funds thereupon became an unexpected gain and a "windfall", if you please.

The word "windfall" is not opprobrious if properly used, but even so, its use should not be permitted to mislead, deceive or prejudice the Jury's consideration of value as a measure of just compensation.

The term "excess mortgage proceeds" or "windfall" first crept into the trial of the case during the testimony of one

of the Owner's appraiser-witnesses. He was being examined concerning the probability of the necessity for a rental increase based upon increased operating expenses and the penses in order to maintain the level of capitalized net income. The witness recognized the contingency of a rate increase based upon increased operating expenses and the vacancy factor. He was then asked if he was aware of FHA policy to the effect that in the event of excess mortgage proceeds, such excess was taken into consideration in the exercise of the FHA's contractual right to "fix rates and charges". The witness testified that he was aware that this supposed FHA policy was a controversial point, but didn't know just what the FHA was doing about it. Whereupon, the Government then sought to question the witness concerning certain letters purporting to set forth FHA policy on all military housing, to the effect that the excess mortgage proceeds, if any, would be taken into consideration in processing applications for rent increases. The word "windfall" was freely used in these letters to characterize the receipt of mortgage proceeds in excess of the cost of construction of a federal housing project. When Government's counsel read from one of the letters, using the word "windfall clearance", counsel for the Owner objected, and the Court instructed the Jury to disregard the word "windfall" as being inadvertently used by the Government's counsel. Government's counsel answered that while he was cognizant of the provisions of the pretrial order in that regard, he did not interpret it to exclude use of the word "windfall" where it appeared in documentary evidence. He was instructed

to henceforth use the term "excess mortgage proceeds" wherever the word "windfall" appeared in the documents. At one point, Government's counsel again used the term "in the event of windfall settlement agreement" and was admonished not to do it anymore.

The following day and outside the hearing of the Jury, the Court stated that when on pretrial it had ordered the word "windfall" not be used, it was not aware that the word would be contained in the FHA letters, documents and policies admitted in evidence; and, in view of the fact that the word did appear in these letters, which had been admitted in evidence, the pretrial order could not be adhered to without changing the wording of the exhibits which, of course, the Court could not do. "So," said the Court, "I am changing the pretrial order and leaving that part out which states that 'windfall' will not be used." The Owner took exception, and Government counsel then said that "the spirit of the pretrial order will still be followed * * *" and that "I will attempt at all times to use 'excess mortgage proceeds', but sometimes it is possible that maybe we can't without changing the letter."

Thereafter, during the trial of the case, the Government's witness-appraisers testified in effect that the Government's policy, as evidenced by the letters introduced in evidence, was relevant to the risk factor or multiplier for determining rate of return. One of the owner-appraisers said that this policy caused him to lower his rate of return from 7 percent to 6.67 percent. It was in this vein that excess mortgage

proceeds was referred to in connection with FHA policy on requests for increased rentals.

During examination of one of the Government's witnesses on FHA policy with respect to excess mortgage proceeds, the witness was permitted to testify to FHA's concern with the "congressional investigation relative to the designation of 'windfalls'." Counsel interrupted to inquire if he understood windfall and excess mortgage proceeds to be substantially the same. He replied that they were "synonymous"; that he preferred to use "excess mortgage proceeds" but that the term "windfall" had "gotten into such common usage that I almost automatically use that term for identification." And, it is true that Congress subsequently enacted "anti-windfall" legislation.

The Owner strenuously contends that the FHA policy letters should not have been admitted in evidence because the letters were not promulgated in compliance with the Federal Register or Federal Administrative Procedure Act, and did not, therefore, rise to the dignity of an administrative regulation. The Government concedes this and says that they were not offered as having the "force and effect of law", but they were, nevertheless, relevant to the risk factor in arriving at a rate of return. Under the lease contract, the FHA, as we have seen, was empowered to regulate rates, charges, capital structure, rate of returns, and methods of operations, and it was certainly relevant for a prospective purchaser to know that in the event increased rentals were needed in order to maintain the level of capitalized income, the FHA would invoke its policy in the face of excess mort-

gage proceeds. This was the extent to which the excess mortgage proceeds and windfall was used in the Government's case, and it was not irrelevant for that purpose.

In the circumstances of this case, it was not improper for the trial court to relax the pretrial order to permit reference to the windfall as it was used in the documentary evidence. Pretrial orders are, to be sure, blueprints for the trial which ought not to be relaxed in the absence of good cause, but they are not hoops of steel and may always be modified in the interest of the administration of justice.

The question remains whether reference to the excess mortgage proceeds and windfall in Government counsel's closing argument was so fundamentally prejudicial as to warrant notice of it here when it was not objected to at trial. In the course of his argument one Government counsel referred to the $365,000 of excess mortgage proceeds and stated, "Well, sure ladies and gentlemen, they ought to have a profit, but I'm telling you, $365,000 plus income for five or six years, plus $167,000 in the reserve for replacement that they got, plus what they are claiming here now is over $1,000,000. I say that's a pretty fair profit; and I think if this profit is increased only by $290,000 to $302,000, you've got pretty fair profit".

Another Government attorney mentioned the "excess mortgage proceeds or windfall" in his argument. In his closing argument counsel for the Owner met the issue squarely and defended the receipt of the proceeds as compensation for the risk involved with the argument that the excess

mortgage proceeds had nothing to do with value, and reference to them as a windfall was a "ghost" which had been killed by the Government's own star witness.[8]

Counsel may, of course, respond to argument without risk of later being estopped from complaining of it as reversible

[8] "Well, let's look at the windfall. He has just referred to it. He has counted that, he has counted the profit and set before you a vast sum of money as being that which these people now have, which they have derived for nothing. That is not true.

"They worked for it. They risked half a million dollars. He says they had contracts signed. That is pure speculation on his part. There is no evidence on it.

"But let's get to the meat of it. As this case developed, I am certain that you were led to believe that this was something that really affected value. It was going to cause value to go down.

"How? By the devious, circuitous route, not that anybody was entitled to recover that, to take it away from the Sill Corporation, but sometime in the future it might become necessary to request a rental increase and when that request was made — I don't even know how much it was going to be for, that's a guess — but when it was going to be made, FHA would reject it. FHA doesn't reject these in whole. Sometimes it's in part.

"But let's say it's to be rejected in whole. What then does that have to do with value in this case? Wouldn't we like to know what effect it would have on the value of this property as of the date of taking?

"Ladies and gentlemen, you were told, you were told by a witness no less than Mr. Sealy, you will recall when I stood there at the podium and talked with Mr. Sealy, I asked him the question, what would have been the effect upon your opinion of value if as you believe there had not been a windfall?

"And what did he say? He said that instead of using that multiplier of 6.67, he would have have used a higher multiplier, thereby giving a greater value. He would have used a multiplier of 7. The difference between the two is decimal 33.

"You take decimal 33, multiply your equity income, $68,241, and ladies and gentlemen, this ghost, this tremendous burden, this penalty — what does it amount to? Believe this if you will, go through that multiplication and we are talking about $22,519.

"What is that per unit? $45.04.

"If this is something that does reduce it, this is something that might reduce it, if a rent request were made and if it were rejected — when, for how much and with what result, we don't know.

"Ladies and gentlemen, Mr. Sealy, the Government's star witness, killed that ghost. It's out of this case. It's dead and gone."

error. But the response does serve to put the whole matter in its proper perspective for appraisal of its prejudicial effect on the jury.

The Supreme Court has laid down the ground rules to govern representatives of the Government in presenting its case to a jury. It is said that Government's counsel "may prosecute with earnestness and vigor — indeed, he should do so. But, while he may strike hard blows, he is not at liberty to strike foul ones. It is as much his duty to refrain from improper methods calculated to produce a wrongful conviction as it is to use every legitimate means to bring about a just one." *Viereck v. United States*, 318 U.S. 236, 248.

And, it is the responsibility of the trial judge, as the governor of the trial, to see to it that counsel remain within the bounds of the record on oral argument — that they strike no foul blows. It ought not be incumbent upon counsel to interrupt the argument. The Court ought to take the initiative where counsel is plainly inflammatory. See: *New York Central R.R. Co. v. Johnson*, 279 U.S. 310. We have followed the established rule to the effect that the "* * * appellate courts will correct error in rare instances where it appears that a verdict was the result of passion aroused through extreme argument which clearly stirred the resentment and aroused the prejudice of the jury even though no objection was made or exception taken at the time." See: *Metropolitan Life Ins. Co. v. Banion*, 106 F. 2d 561. Also see: *Smith v. Welch* (10 CA), 189 F. 2d 832.

It is evident that from the very beginning the Court was concerned with the prejudicial effect of the excess mortgage proceeds when characterized as a windfall. At one point in the pretrial, while the word "windfall" was under discussion, the Court addressed Government's counsel saying, "Do you have any authority that permits you to go to the jury with the story about windfalls?" and then said, "I'm talking about the Court making an error letting it in to prejudice the jury against these defendants." and, again, "Well, here's the point. If you want to use the 'windfall' for an advantage with the jury, the Court doesn't want you to use it." The trial court adhered to the pretrial plan to preclude reference to the word "windfall", until it appeared as accepted terminology in the documentary evidence. It was only then that the pretrial rule was relaxed to permit its use, and we think properly so.

In weighing the propriety of reference to the term of oral argument, it is significant, we think, that after all, the excess mortgage proceeds did prove to be a windfall and, as such, it was not wholly irrelevant to the ultimate issue of just compensation. The Owner did receive the $167,000 representing the replacement fund, and the receipt of this sum, as we have seen, was relevant to the critical issue. Then, too, it is noteworthy that the issue squarely presented to the Jury by the Owner's oral argument was whether it would accept the Government's appraisal based on its theory of capitalization of income or the appraisal of the Owner based upon its theory. In this setting, we do not think it wholly improper for Government counsel to call attention to the

amount of money the Owner had already received in determining which of the divergent theories the Jury would choose in awarding "just compensation".

It may well be that reference to the receipt of these funds was over-emphasized, but we cannot say that it was so violent and perversive as to defeat the ends of justice.

The judgment is affirmed.

APPENDIX B
CAPITALIZATION OF INCOME

NOTE: In capitalizing income to determine value, the net income is divided by the desired percent of return on capital, *e.g.*, $10,000 capitalized at 5% would give $200,000 ($10,000/.05). Instead of dividing net income by the capitalization percent the rate can be converted into a "multiplier" by first dividing the rate into 1.00, *e.g.*, a rate of 5% gives a multiplier of 20 (1.00/.05), and then multiply the net income ($10,000 x 20 = $200,000). Since the higher the capitalization rate, the lower the "multiplier", the *higher* the capitalization *rate*, the *lower* of amount of value computed, *e.g.*, a capitalization rate of 20% will produce a value four times less than 5% (*e.g.*, $10,000 capitalization at 20% equals $50,000).

Since the investor wants not only a return on his capital but also a return *of* his capital over a given period of time, present worth tables are consulted to find the exact multiplier (*e.g.*, $50,000 capitalized at 6% for 30 years, a multiplier of 13.7648, equals $688,242.00, in other words, an investment of $688,242.00 would be repaid with 6% interest by 30 annual payments of $50,000). The *shorter* the period of time in which to return capital, the *lower* the value, especially when a *low* capitalization rate is used — a high capitalization rate lowers indicated value so substantially that it is not as affected by a short period to return capital. (*E.g.*, $50,000 capitalized *6% for 15* years equals $485,612; for *40* years it equals $752,315; $50,000 capitalized *18%* for *15* years equals $254,579; for *40* years it equals $277,408).

The following determinations are involved in the capitalization process:

(1) Gross Income (on rent producing property will involve estimates of occupancy, etc.).

(2) Net Income (will involve estimates of operating costs and other expenses sufficient to maintain property at income producing level).

(3) Capitalization Rate (selection of the fair interest rate on the investment capital).

(4) Capital Recapture (period of time over which investment capital will be returned — will involve estimate of useful life of project).

The Government's method was to deduct debt service (principal, interest, and insurance premium or mortgage) as an expense in computing net income and then to capitalize this net cash flow at a high interest rate (15% to 21%) to produce a figure that the Government claimed indicates the owner's equity value. Petitioner submits, debt service should not be deducted from net income and that the *overall value* of the property should be determined and then the outstanding mortgage should be subtracted to give owner's net equity value. For application of standard method to Wherry Project see *United States v. Certain Interests in Cascade County, etc.*, 205 F. Supp. 745, 763 (Mont. 1962).

COMPARISON OF STANDARD METHOD AND GOVERNMENT METHOD

ASSUMPTION: The *same identical piece of property* is involved that produces an annual *net income* of $300,000, it is further assumed that on the date of evaluation in (a) the property has no mortgage; in (b) a $1,000,000 mortgage balance with annual debt service of $62,500; in (c) a $2,000,000 mortgage balance with annual debt service of $125,000; or in (d) a $4,000,000 mortgage balance with annual debt service of $250,000.

I
STANDARD METHOD

(capitalization of net income and then deduction of outstanding mortgage to determine owner's equity value)

Capitalization Rate — 6% for 40 years

(a) $300,000 net income — 6% 40 year value	$4,513,889
minus mortgage balance	—0—
owner's value	$4,513,889
(b) $300,000 net income — 6% 40 year value	$4,513,889
$1,000,000 mortgage — ($62,000 debt service) minus mortgage balance	1,000,000
owner's value	$3,513,889
(c) $300,000 net income — 6% 40 year value	$4,513,889
$2,000,000 mortgage ($125,000 debt service) minus mortgage balance	2,000,000
owner's value	$2,513,889
(d) $300,000 net income — 6% 40 year value	$4,513,889
$4,000,000 mortgage ($250,000 debt serv.) minus mortgage balance	4,000,000
owner's value	$ 513,889

II
GOVERNMENT'S METHOD

(straight capitalization of net income *after* deduction of debt service to determining owner's equity value)

Capitalization Rate 18% — Straight
(Government used 15 and 21% at trial)

(a) $300,000 net income — no mortgage — 18% — *owner's value*	$1,666,666
(b) $300,000 net income — $1,000,000 mortgage, $62,500 debt service, $237,500 at 18% *owner's value*	$1,319,448
(c) $300,000 net income — $2,000,000 mortgage, $125,000 debt service, $175,000 — 18% *owner's value*	$ 972,222
(d) $300,000 net income — $4,000,000 mortgage, $250,000 debt service, $50,000 at 18% *owner's value*	$ 277,777

TEST: Fair market value of Owner's equity interest plus outstanding mortgage balance should equal overall value of property. (assuming fair market value of property exceeds amount of mortgage which would exist in all cases where the owner's interest exceeds zero)

I
STANDARD METHOD

Mortgage Balance		*Owner's value*		*Overall value*
(a) No mortgage	plus	$4,513,889	equals	$4,513,889
(b) $1,000,000	plus	3,513,889	equals	4,513,889
(c) $2,000,000	plus	2,513,889	equals	4,513,889
(d) $4,000,000	plus	513,889	equals	4,513,889

II
GOVERNMENT'S METHOD

Mortgage Balance		*Owner's value*		*Overall value*
(a) No mortgage	plus	$1,666,666	equals	$1,666,666
(b) $1,000,000	plus	1,319,448	equals	2,319,448
(c) $2,000,000	plus	972,222	equals	2,972,222
(d) $4,000,000	plus	277,777	equals	4,277,777

Petitioner submits the Government method, both economically and mathematically, is *totally wrong*, viz: The *same piece of property* cannot have a *total value* of from $1,666,666 to $4,277,777 depending on whether there is no mortgage or a $4,000,000 mortgage. The overall value of the same identical property should remain constant whether it has a mortgage or no mortgage. Under the Government's method it varies. The capitalization of net income after deducting debt service produces a meaningless figure that has no relationship to either the owner's equity value or the overall value of the property. See discussion and reasoning in *De Luz Homes v. County of San Diego*, 45 Cal. 2d 546, 290 P. 2d 544, 557 (1955).